Limited Liability Companies

Starting a business is a daunting task; capital must be raised, business models must be developed, company logos must be selected. But before a single customer can be served, a business entity must be chosen. How a business is formed can determine how the business is governed, how liability will be shared and how taxes will be paid. Generally, there are three types of business entities: partnerships, corporations and limited liability companies (LLC). Each of these formations addresses liability, taxes, governance and growth differently.

A partnership is a very simple business entity. Partnerships can be formed on a handshake and run very informally. Partnerships do not pay tax, but the partners are taxed on money they derive from the business. Though simple to operate and cheap to run, the drawback of forming a partnership is that they offer no liability protection, which can limit how large they grow and their access to new capital. The specter of risk is ever present in business. In a partnership, should one partner harm someone, the other partners are open to personal liability. For example: image a small delivery service with two partners, Rich and Poore. Rich is rather wealthy, while Poore is less fortunate. While on a delivery, Poore is involved in a traffic accident. The injured person can sue Rich for the injury simply because he is a partner in the business. Damages are not limited to the partnership's profits, but can extend to each partner's personal wealth. So, even though Rich was not involved in the accident, he must pay for the mistakes of Poore. This inability to shield one's personal liability dissuades others from joining the partnership, which can inhibit access to new capital and stifle growth.

The corporate form provides a liability shield and allows for growth, but require more formalities and profits are taxed twice. When a corporation is formed, capital is raised by selling an interest in the business to stockholders. In exchange for their investment, stockholders have some say in how the business is run. While they do not run day-to-day operations, a stockholder can vote to appoint a representative to the company in their place. These representatives form the board of directors. The board makes the "big decisions," while daily operations are managed by corporate officers selected by the board. As the business generates money, the profits can be funneled back to the stockholders though dividends. However, before a dividend can be paid, the business must pay corporate taxes. The stockholders must then pay tax on the dividends they receive. Though this two-tiered tax obligation is unattractive and corporate formalities may be cumbersome, corporations limit a stockholder's personal liability. Imagine that Rich and Poore's delivery service is a corporation. The injured person cannot sue Rich for owning an interest in the business, but can sue the corporation and Poore, since he caused the injury. This liability shield encourages individuals to invest in the business. New investments can then be used to grow the business by expanding its presence into new markets or developing new services.

An LLC is a flexible business entity. In essence, it allows its members to blend the attributes of a partnership with a corporation. Like a corporation, members are personally liable for their own actions and liability of the business is limited to the LLC's value. Since liability is limited, growth and investment are not stifled. Though forming an LLC requires more paperwork than a partnership, the internal governance of an LLC can be very informal. As for taxes, the members can choose how to be taxed, depending on which tax model is best for the business. The flexibility of an LLC makes it a very attractive corporate entity.

The form of a business entity is almost as important as the services the business provides. Great consideration must be taken when selecting a business form, as the type selected will dictate how the business will function and develop.